

**STRANDED COST COMMENTS OF APPALACHIAN POWER COMPANY
IN RESPONSE TO THE SCC STAFF'S APRIL 30, 2003 REQUEST FOR COMMENTS**

On April 30, 2003, the State Corporation Commission Staff ("Staff") confirmed that the April 29, 2003 meeting of the Stranded Cost Working Group would be the final meeting on the first phase of the Working Group study.¹ The Staff requested written comments on any recommendations for legislative or administrative action to address over-recovery or under-recovery of just and reasonable net stranded costs. In addition, the Staff requested written comments on the several stranded cost monitoring proposals circulated in the Working Group meetings and in writing among the participants. Appalachian Power Company, d/b/a American Electric Power ("Appalachian" or "Company"), provides these comments in response to the Staff's invitation.

1. Legislative Changes to Address Stranded Cost Recovery

The Staff has requested comments from the participants in the Working Group addressing paragraph 9 of the Legislative Transition Task Force ("LTTF") resolution establishing this study. Paragraph 9 provides for the Staff to: "Include in its reports to the LTTF any recommendations for legislative or administrative action that the Commission, the work group, or both, determine to be appropriate in order to address any over-recovery or under-recovery of just and reasonable net stranded costs". The Commission Staff has asked Working Group participants to: "Please discuss whether the definitions and/or methodologies discussed by the work group might require any actions as contemplated by Requested Action #9. Discuss what action may be necessary, the timing of that action, and why it is necessary." Appalachian will address generally legislative issues which would relate to actions that the LTTF should take in response to its statutory

¹ Electronic mail message from Susan Larsen, dated April 30, 2003.

obligation to monitor stranded cost recovery, but which would be independent of any initiative suggesting quantification of stranded costs and their recovery. However, recognizing that legislative comments may be premature under the language of the resolution, Appalachian reserves the right to argue additional legislative issues as they may arise before the LTTF and the General Assembly.²

The question of whether the recovery of stranded costs has resulted or is likely to result in over- or under-recovery of such costs should be answered within the context that recovery is proper only to the extent that customer choice develops in accord with the terms of the Virginia Electric Utility Restructuring Act (“Act”). The Act provides that each incumbent electric utility shall only recover its just and reasonable net stranded costs through either capped rates or wires charges. It further provides that the LTTF shall monitor whether recovery has resulted or is likely to result in over- or under-recovery. It does not require quantification of stranded costs or quantification of their recovery.

Stranded costs do not, and will not, exist in the absence of a competitive market (i.e., customers being served at market-based rates). The Act envisions that all customers will be served at competitive market-based generation rates, either by exercising choice or through the default service mechanism, by not later than July 1, 2007. It was on the basis of these provisions that the stranded cost recovery features of the Act were fashioned. Incumbent utilities were allowed to recover, through capped rates and wires charges, costs that will be stranded upon implementation of customer choice and market-based rates. Thus, to the extent that market-based

² Paragraph 9 requests recommendations for legislative and administrative action “to address any overrecovery or underrecovery of just and reasonable net stranded costs.” A response to paragraph 9 is premature at this stage of the study. Proposed actions to address “any overrecovery or underrecovery” should await a determination that an under-recovery or over-recovery exists or is likely to exist. In addition, the Company has no recommendations for administrative actions at this point for the same reason. If, on the basis of the Dominion monitoring methodology, the stranded cost recovery provisions were shown to be performing in an unexpected or unacceptable manner, administrative actions by the Commission might be appropriate.

rates are not applied to all customers on or before July 1, 2007, because of unintended disruptions of Virginia's plan, the stranded cost and other provisions of the Act would need to be changed.

At this stage, the LTTF's obligation to determine whether over- or under-recoveries of stranded costs have resulted, or are likely to result, should be satisfied by a timely assessment of whether customer choice and market-based pricing will be implemented as the legislature intended and the Act provides. If the LTTF determines that a competitive market will not develop as planned, and that market-based pricing for all customers on and after July 1, 2007 will not be implemented, it could then take action to identify and propose legislation.

House Bill 2453, approved by the 2003 General Assembly, served to modify the Act to require that incumbent utilities transfer control of their transmission facilities to regional transmission organizations no earlier than July 1, 2004, yet prior to January 1, 2005. The Company suggests that January 1, 2005 represents a reasonable date by which the LTTF should recommend to the legislature alternatives to the requirements of the Act if substantive evidence does not exist which suggests that choice and market-based pricing for all customers as of July 1, 2007 continues to be a viable option.

The Company recommends that the LTTF adopt a resolution providing for an ongoing assessment of whether customer choice and market-based pricing will be implemented as provided by the Act, and thus whether stranded cost recovery by incumbent utilities continues to be appropriate.

2. Monitoring of Stranded Cost Recovery

Working Group participants have proposed two methodologies to monitor stranded cost recoveries, one that comports with the Act and one that does not.³ Dominion Virginia Power (“Dominion”) has presented a methodology that is generally consistent with monitoring the performance of the stranded cost recovery mechanism embodied in the Act. The other methodology (“Staff / Committees model”) would result in a return to traditional utility rate regulation analyses, a result that the Company considers beyond the direction in either the Act or the resolution establishing this Working Group study effort issued by the LTTF.

A. The Applicable Provisions of the Act.

The Act contains provisions carefully crafted to give rate certainty to incumbent electric utilities, such as Appalachian, and to their customers during the transition to competition. Section 56-582 limits the rates a utility may charge for generation services through July 1, 2007. The utility is entitled to an opportunity to collect the revenue levels reflected in its regulated rates as effective on July 1, 1999 (“capped rates”) and no more.⁴ Likewise, the utility’s customers are entitled to electric service provided at the capped rates through July 1, 2007.⁵

Other provisions of the Act establish a privilege for customers to leave the generation service of the utility and choose another generation supplier, however. Thus, customers have

³ The Staff has made two methodology presentations that it asserts are, or can be complimentary, although it also said it prefers the proposal made at the Working Group’s meeting on April 7, 2003 to the second proposal presented at the April 29 meeting. In addition, the Virginia Committee For Fair Utility Rates and the Old Dominion Committee For Fair Utility Rates (“Committees”), groups of industrial customers of Dominion Virginia Power and Appalachian respectively, also presented a proposal that combined the two Staff proposals, but added some modifications to the Staff’s presentations. All of these proposals are objectionable for the same reasons and are treated as one “methodology” for purposes of these comments.

⁴ Capped rates may be adjusted for limited reasons. However, there is nothing in the Act that resembles the broad-based examination of the “cost-of-service regulation” involved in traditional electric utility rate-making.

⁵ Capped rates could be terminated before July 1, 2007 only if the Commission found that prices would be limited by effective competition after the termination.

both the opportunity to shop for a lower-price generation supplier and the certainty of capped rates if a lower generation price is not available.

Customer choice does not remove a utility's opportunity to collect the revenue levels reflected in its capped rates. Rather, the Act provides that, if a customer switches generation suppliers, the utility may sell on the market the generation that would otherwise have served the switching customer ("displaced generation"). Any part of the capped revenue not recovered in the market price for displaced generation would be recovered in a wires charge under § 56-583 of the Act. Thus, until July 1, 2007, the Act provides for an opportunity for the utility to collect the revenue levels in its capped rates.

Section 56-584 is a simple declaration that any stranded costs, to the extent they exceed zero value in total, "shall be recoverable" through capped rates or wires charges. It creates no process other than the provisions of §§ 56-582 and 56-583 for stranded cost recovery nor any process to adjust capped rates or wires charges. In fact, it states the opposite. The incumbent's only sources of stranded cost recovery are capped rates and wires charges through the transition period. Section 56-595 C (iii) provides only that the LTTF, with the assistance of the Commission and others, shall monitor the stranded cost recovery contemplated in § 56-584. It says nothing about calculating total stranded costs, and such a calculation is not necessary to the process set forth in the Act.

Section 56-595 C (iii) cannot be read to require or permit a methodology to monitor whether the capped rate revenue level is inadequate or excessive. There is no authority for the monitoring methodology to compare capped rate revenue levels to some other calculated revenue level based on a cost-of-service analysis as would be done in a traditional utility rate case. There is no mention of the "calculation" or "projection" of anything in § 56-595 C (iii), let alone the

calculation or projection of total stranded costs.⁶ The monitoring that should be required is to determine if the capped rate and wires charges mechanism for switching customers is performing as contemplated to keep the incumbent utility indifferent as to whether a customer switches generation suppliers before July 1, 2007.⁷

The first numbered paragraph of the LTTF resolution establishing this study anticipates that the recommendations under consideration at this stage will be “consistent with the provisions of the Act”. As will be discussed herein, only Dominion has proposed a methodology arguably consistent with the Act. The other methodological presentations to the Working Group clearly go beyond the current provisions of the law.

B. Dominion Virginia Power Methodology

In order to implement the wires charges mechanism in § 56-583, the Commission must project market prices for generation sales. This is an express requirement in the wires charges provisions of § 56-583. Compared to actual experience, projected market prices that are too low could increase wires charges to a level that would over-recover revenues that are intended to cover stranded costs. Projections that are too high could decrease wires charges to a level that would under-recover revenues that are intended to cover stranded costs. Accordingly, Dominion proposed a method that would, in part, monitor the accuracy of the Commission’s projections of market prices as compared to actual market prices experienced after the projection. Such a

⁶ The Staff and Committees proceed from an assumption that the only means to monitor stranded cost recovery is to calculate total stranded costs. There is nothing in the Act that suggests any basis for such an assumption, and its acceptance would require substantial changes to the Act, including changes to the sections governing capped rates and wires charges. The Commission has properly determined that no calculation of total stranded costs is necessary under the Act. Application of Northern Virginia Elec. Coop., for review of tariffs and terms and conditions of service, Case No. PUE-2002-00086, Final Order at 2, n. 3 (June 18, 2002).

⁷ The Commission has correctly determined that the Act is intended to keep the utility indifferent in this regard under the wires charges provision of the Act. Commonwealth of Virginia, at the relation of the State Corporation Commission, Ex Parte: In the matter of considering requirements relating to wires charges pursuant to the Virginia Electric Utility Restructuring Act, Case No. PUE-2001-00306, Final Order, at 25 (November 19, 2001).

process would monitor the adequacy of the wires charge process and would be clearly within the current provisions of the Act. To this extent at least, the Dominion methodology appears to be consistent with the Act, and Appalachian has no further comment on the Dominion model at this point.

C. Staff / Committees Model

Neither the two proposals of the Staff nor the presentation of the Committees on April 29 are consistent with the Act. All of them suffer from the same overriding flaw. Rather than monitor the performance of the capped rate and wires charges provisions of the Act, each of these methodologies appears directed at re-evaluation of the reasonableness of capped rate revenue levels. As stated previously, nothing in the Act even suggests that the stranded cost monitoring process should become a broad re-evaluation of capped rate revenue levels.

The first proposal of the Staff was described orally at the Working Group session on April 7, 2003. Using graphs drawn on a chalkboard to illustrate the concepts, Staff representatives made clear that the revenue level produced by capped rates could vary under the methodology based on an evaluation of costs and a fair rate of return – the traditional utility rate-making standard. On April 29, both the Staff and the Committees made similar assertions. The Staff wrote: “Recovery of stranded costs occurs throughout the capped rate period to the extent actual earnings exceed costs plus a fair return. These recoveries can be calculated and monitored using the earnings test mechanism.” The Committees asserted in part that stranded costs are recovered in capped rates “to the extent that capped rates exceed actual and likely costs including a fair return”

The revenue levels produced by capped rates were set by the Commission and adopted in the Act, and they are presumed to be just and reasonable. For capped rates to produce revenues

in excess of costs plus a fair rate of return as the Staff / Committees model suggests, a rate case type of analysis would be required to second-guess the capped rates already established by Commission order and by statute. According to the Staff's presentations in the Working Group, factors such as an incumbent's authorized rate of return on equity capital might be subject to change in such an analysis of capped rates. The process would simply devolve into time consuming and expensive analyses that would be the equivalent of annual rate cases.

The goal of re-evaluation of capped rates is unclear. Expressly, it is to determine the amount of capped rate revenue that is available to cover stranded costs. However, unless capped rates or wires charges would be adjusted on the basis of the re-evaluations, there would be no effect on customers, positive or negative. And, suppose the re-evaluation showed that capped rates were too low to cover costs plus a fair return. Would they be increased to meet the cost plus a fair return standard? Would they be increased further to provide some excess over costs plus a fair return in order to cover all or a portion of stranded costs made recoverable by § 56-584?

The General Assembly provided in the current provisions of the Act only for increases or decreases in capped rates to a limited extent currently stated in the law. Section 56-595 C (iii) of the Act should not be interpreted to suggest that the General Assembly also adopted, silently through general language requiring the monitoring of stranded cost recovery, a process that permits unlimited increases or decreases in capped rates. The only objective reading of the current legislation as a whole is to conclude that the General Assembly intended neither to increase nor decrease capped rates prior to July 1, 2007 except in the limited manner expressly stated in the Act. For this reason, the methodology suggested by the Staff and the Committees is either inconsistent with the capped rate provisions of the Act because it would contemplate

changing capped rates for reasons not set forth in the Act, or it would require time-consuming and expensive rate analyses and proceedings, with little or no impact on customers and raising utilities' costs without tangible benefit to either customers or companies.

In commenting on the Staff's April 7 presentation to the Working Group meeting, Appalachian said: "The Staff model would require fundamental changes in the Act and would be little different than traditional utility rate regulation." The subsequent presentations of the Staff and the Committees have confirmed this comment. As described previously, the methodology proposed by Staff and Committees is inconsistent with the capped rate and wires charges provisions of the Act. However, the Staff / Committees model is inconsistent with other provisions of the Act as well.

For example, the Committees' presentation of April 29 states: "As is true of any administrative method of determining stranded costs, the above approach [the Staff / Committees methodology] involves estimates based on long-term revenue and cost projections." The methodology proposed by the Staff and the Committees expressly requires an "administrative determination" of stranded costs. The Act seeks to avoid administrative determinations of stranded cost.

The Staff, in its presentation on April 29, said: "A bundled earnings test should be used until such time as bundled, capped rates are terminated. It is proper to use a bundled earnings test since all earnings produced under bundled, capped rates that are in excess of actual costs plus a fair return can be used to mitigate stranded cost exposure." The suggestion that cost reductions in distribution and transmission functions should be used to offset stranded generation costs is inconsistent with the provisions of § 56-590 prohibiting one utility function from subsidizing another. In Appalachian's functional separation case, the Commission has made

clear that it will not permit such subsidies.⁸ There is nothing in the Act that suggests that § 56-595 C (iii) reverses the anti-subsidy language of § 56-590.

The Staff should report to the LTTF that the methodology proposed by it and the Committees would be inconsistent with the current provisions of the Act. As described previously, the Staff / Committees proposals would require changes in fundamental precepts of the Act, such as limited adjustments to capped rates and functional separation of incumbent utilities without subsidies among the separated functions. Specific amendments to the Act should be set forth in the Staff's report to give Working Group participants an adequate opportunity to address them before the LTTF and the General Assembly.

⁸ Application of Appalachian Power Company d/b/a American Electric Power-Virginia, for approval of functional separation plan, Case No. PUE-2001-00011, Order On Functional Separation, at 11-13 (December 18, 2001).